

# **OVERVIEW OF 2003-04 BUDGET BILL**

## **SELECTED MAJOR ISSUES**

Downsizing the California Youth Authority  
Childcare and Development  
Revenue and Tax Proposal

## **DOWNSIZING THE CALIFORNIA YOUTH AUTHORITY: CHALLENGES AND OPPORTUNITIES**

With a proposed annual budget for 2003-04 of \$414 million, the California Youth Authority (CYA) operates eleven institutions and four fire camps and provides parole supervision for some of the state's most serious juvenile offenders ranging in age from 12 to 25.

In the last seven years, the CYA has experienced dramatic reductions in its caseload. In 1996, more than 10,000 wards were incarcerated at CYA. The ward population is now projected to decline to 5,340 by June 2003. While CYA's population has declined by over 46 percent since 1996, the department's expenditures have failed to decline at a comparable pace. Indeed, expenditures have dropped by only 26 in inflation adjusted dollars over this period. As CYA's ward population has downsized, many fixed costs have retained intact. In addition, public scrutiny, litigation and legislative concerns have fueled the demand for additional funding to improve treatment programs.

When reflecting on these trends in recent budget deliberations, legislators raised concerns about CYA's response. This essay evaluates the fiscal and policy implications of the population changes at CYA. Specifically:

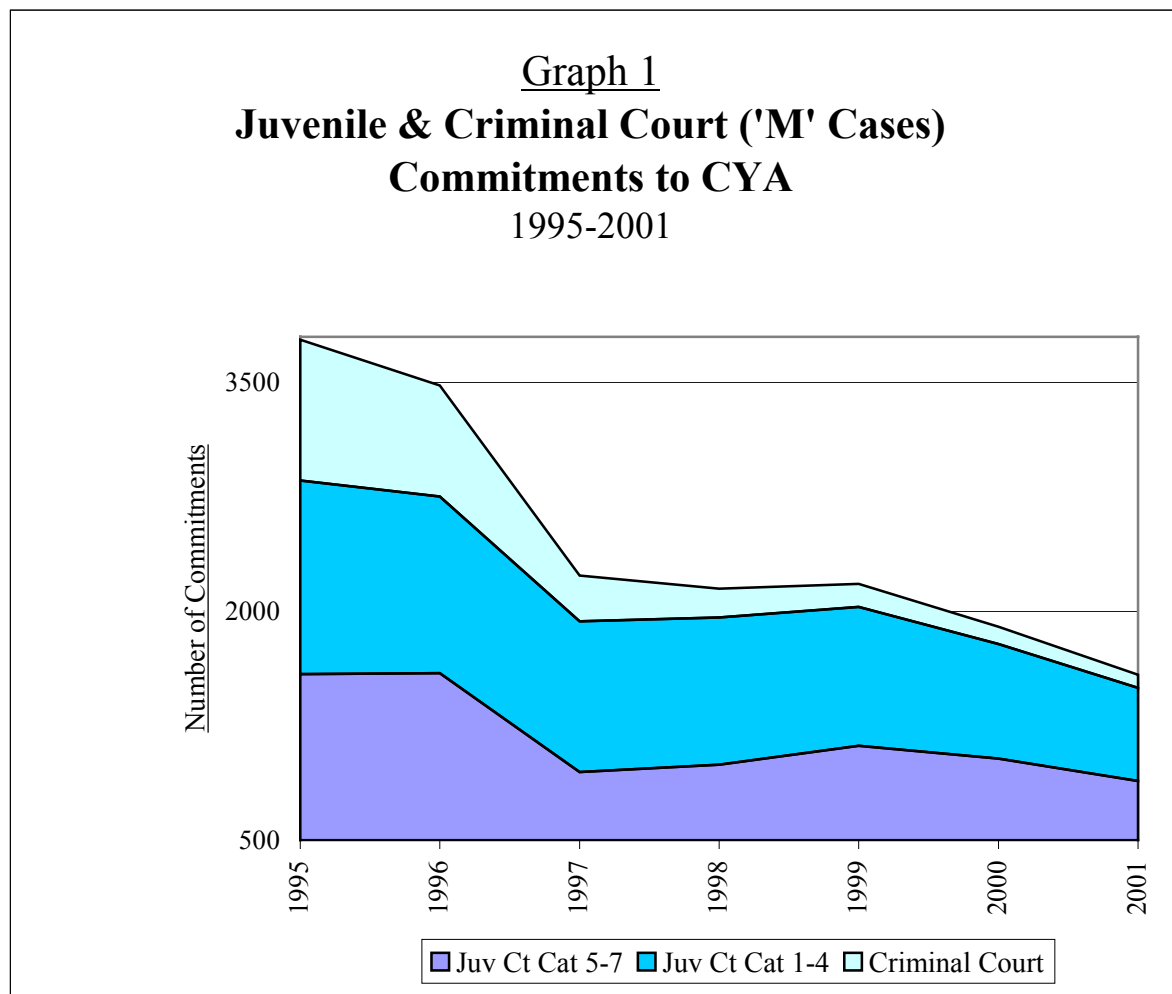
- To what extent has the population dropped, and what are the most likely factors for the decline?
- How has CYA responded to the population changes?
- What options can the Legislature exercise to reduce costs or increase accountability?

### **Population Decline Significant**

Looking at CYA new admissions – the institutions' "front door" -- juvenile and criminal ("M" cases) commitments to CYA have dropped by nearly 60 percent since

1996 from 3,800 to 1,600. Much of this decline has been influenced by policy changes adopted by the Legislature and the Governor. Significantly, this decline has occurred across all offense categories – not just among lower level offender categories.

As illustrated by Graph 1, the decline since 1995 for category 1-4 offenders – committed for more serious crimes – was 52 percent. Youthful offenders in categories 5-7 – committed for relatively less serious crimes – has declined by 40 percent.



## Causes

Several factors appear to be contributing to the continuing decline in CYA's ward population, including: (1) the transfer of criminal court "M" cases to the

Department of Corrections (CDC); (2) the imposition of “sliding scale” fees on counties; (3) the development of local prevention programs and detention alternatives; (4) the decline in juvenile crime; and (5) the perception by judges that CYA lacks adequate and appropriate treatment.

1. ***Transfer of “M” Cases.*** In June of 1994, 16 percent of CYA’s population was comprised of persons who were convicted in criminal court when they were under the age of 21. These so-called “M” cases were ordered by the court to serve their time at CYA. In 1996, the law was changed to limit the housing of “M” cases in CYA to only inmates under the age of 18. As a result, 824 inmates were transferred that year from CYA to CDC. By 2001, only 74 “M” cases were admitted to CYA.
2. ***Sliding Scale Fee Legislation.*** Prior to 1995, counties paid the state a negligible amount -- \$25 per offender per month – to commit wards to CYA. In 1995, legislation was enacted to establish a new fee structure, which provided incentives for counties to treat less serious offenders in county-level placements, thereby reducing their dependence on costly CYA commitments. Legislation enacted in 1998 froze the per capita costs on which the sliding scale fees are based at the levels in effect on January 1, 1997. Under the sliding scale monthly fee schedule, counties pay 100 percent of the average cost for category 7 wards (\$2,600), 75 percent for “category 6 wards (\$1,950), and 50 percent for category 5 wards (\$1,300). In addition, the fee for category 1- 4 wards has increased from \$25 to \$150 per month. Counties now pay \$52.1 million annually for their commitments to CYA. Note: The Governor’s 2003-04 budget assumes enactment of legislation to adjust the sliding scale fees to reflect inflation. This would increase county costs by \$7 million.
3. ***Development of Local Prevention Programs and Detention Alternatives.*** While the sliding scale fees provided a strong fiscal incentive to treat juvenile offenders locally, state policies also have sought to strengthen local juvenile justice programming by encouraging an array of alternatives and graduated sanctions. State funding for Juvenile Justice Challenge Grants and the Repeat Offender Prevention Program has helped counties develop effective approaches to juvenile crime and intensive intervention for high risk, chronic offenders. In 2000, the Legislature established the Juvenile Justice Crime Prevention Act to provide counties with stable funding to maintain and expand programs that work to reduce juvenile crime. In addition, since 1997-98, almost a half billion dollars in state and federal funds have been dedicated to assist counties in renovating and constructing local juvenile facilities. As a result, counties are keeping more of

their offenders locally. Kern County, for example, sent 162 wards to CYA in 1995; in 2001, the county sent only 19.

4. ***Decline in Juvenile Crime.*** California has experienced a remarkable decline in serious juvenile crime, thereby reducing the pool of potential offenders going to CYA. For example:

- Between 1991 and 2000, juvenile arrests for homicide fell from 969 to 160.
- Between 1990 and 2001, the rate of juveniles committing felony offenses dropped by 47 percent (compared to a 25 percent decline for adults during the same period.)

The number of juveniles booked and detailed for serious, violent crimes (Section 707(b) offenses) dropped by almost 50 percent since 1999.

Although California's investment in the local juvenile justice system has influenced the decline in juvenile crime, other factors have also contributed to this trend, which has been experienced across the country. These factors include, among others, changes in demographics, the economy, gang truces, and alternative criminal justice strategies.

5. ***Judicial Perceptions That CYA Provides Inadequate and Inappropriate Treatment.*** In recent years, CYA has become the subject of litigation and intense public scrutiny concerning its conditions of confinement and institutional operations. The Inspector General has investigated and confirmed abuses and management deficiencies consistent with what has been reported publicly. During the past two years, CYA appears to be making concerted efforts to address its many problems. Still, the difficulties faced by the department continue to be extensive, including: CYA's inability to effectively handle gang problems that appear to increasingly interrupt institutional operations; the significant number of wards on restricted programming who are not receiving mandated education services; the lack of adequate formal treatment for sex offenders and drug addicted wards; and an overall inadequacy of mental health services.

Many Probation Chiefs and their staff -- who make placement recommendations to the juvenile court -- are increasingly concerned about these conditions at CYA and are willing to send offenders to CYA only if all local alternatives have failed or are unavailable. It is acknowledged that many juvenile court judges -- who have the ultimate placement responsibility -- have similar concerns. Moreover, some judges

have also raised concerns about the length of time wards stay at CYA. Under current law, judges commit wards to CYA, but it is the Youthful Offender Parole Board (YOPB) that determines how long the ward stays and what treatment is ordered. The YOPB short circuits accountability for CYA wards, increasing judicial frustration and reluctance to send juvenile offenders to CYA in the first place.

## **The CYA Struggles to Respond**

CYA's population has declined by over 45 percent since 1996, but the department's expenditures have not declined at nearly the same rate (expenditures have declined by 26 percent in inflation adjusted dollars over this same period). During this same period, public scrutiny, litigation, and legislative concerns have sought additional funding for improved treatment programs.

1. ***CYA has closed individual living units across the state, instead of closing entire institutions. As a result, per capita costs at CYA have soared.*** Instead of closing institutions to address the declining population, CYA has closed individual living units at each institution. As of November 2002, 24 living units were closed across the state. This policy choice prevents CYA from gaining any of the potentially significant cost savings associated with consolidation and forces the department to continue supporting its full infrastructure and overhead with a smaller budget. As CYA's ward population continues to drop, the average institution cost per ward (adjusted for inflation) has steadily risen from \$43,500 in 1996 to nearly \$66,000 by December 2002
2. ***CYA has increased its spending on mental health treatment programs over the past few years.*** CYA has increased its spending on mental health services and treatment programs over the past few years in response to a growing recognition that many wards sent to CYA have complex mental health issues (also reflecting a lack of county-level facilities and programs for this population). A 2002 report by Stanford University researchers identified extremely high prevalence rates of psychiatric problems among CYA wards and parolees, and significant understaffing in mental health care services. The report also made specific recommendations for an appropriate continuum of care. To address this need, CYA increased mental health staffing at three institutions over the past two fiscal years. In his proposed budget, the Governor has included \$1.45 million to increase staffing for CYA's correctional treatment facilities and \$3.4 million for a new 20 bed inpatient mental health facility to be jointly run by CYA and DMH. Despite the recent augmentations, CYA is still far short of meeting the mental

health needs identified by the Stanford report.

3. ***CYA has cut spending in education because their education budget is driven by a formula devised years ago. As a result of this out-of-date budget formula, CYA is unable to provide adequate education services today.*** Because so much of CYA's budget is population driven, the department has experienced a rapid reduction in some of its funded staffing positions. This is perhaps most evident in the education area, where funding is based on a formula of ward-to-teacher ratios devised decades ago, which is no longer reflective of the department's needs. For example, when the baseline for the education formula was determined, CYA did not provide education to wards on restricted programming. Today they do, but the formula has never been adjusted to include these wards. Theoretically, CYA's population could drop to a point where they would not be budgeted for any teachers, but they could still have close to one thousand wards needing education.
4. ***CYA has reduced spending on parole and aftercare services during the last fiscal year. As a result, CYA may experience higher rates of recidivism.*** To achieve short term savings, budget reductions were adopted that reduced parole and aftercare services. However, research suggests that aftercare services and successful reintegration into the community may be the key components to reducing recidivism. Therefore, while the department may be able to "save" some dollars in the short term by cutting aftercare programs, there may be longer term costs in terms of increased recidivism rates.

### **Legislative Directive to Downsize**

In 2002, legislation was enacted as part of the budget requiring CYA to prepare by November 1, 2002 a written plan to close at least three facilities by June 30, 2007. CYA also is required to close at least one facility pursuant to the plan by June 2004. In addition, Supplemental Report Language was approved requiring CYA, in consultation with the Legislative Analysts Office and the State Department of Education, to review their education funding formula.

As of January 10, 2003, these required reports have not been provided to the Legislature.

---

## Other Options to Improve CYA and Enhance California's Juvenile Justice System

- *Realignment.* This strategy suggests that cost efficiencies and improved outcomes can be achieved by “realigning” program and fiscal responsibilities. In the case of the juvenile justice system, California maintains a bifurcated state-county approach in which the state operates the CYA for the most serious offenders while the counties – mostly probation departments – supervise the rest. In past years, the Legislature has considered proposals to realign juvenile justice programs at the county level. This could be accomplished through a phased in process that transfers to counties the state dollars that are now expended for CYA; counties could then use their resources to contract with CYA for juvenile placements that meet local needs. Any funds not used for state placements could be used by counties for community based programs.
- *Eliminate YOPB.* SB 1793 (Burton) from the 2001-02 session proposed to eliminate YOPB. Eventually, although it was narrowed to shift only length-of-stay and treatment decisions to the juvenile court, the bill was vetoed. CYA would be a more responsive state agency if it were reconnected to its “consumers” – that is, local governments and judges. By shifting parole and treatment order responsibilities to courts, CYA would have a direct link to the source of its commitments rather than a “middleman” state agency. In this way, CYA would be challenged with the kind of marketplace incentives that would lead to more effective correctional treatment and programming for youthful offenders.
- *Retool CYA as a Service Provider to Counties.* CYA could have the infrastructure to provide specialized services which counties cannot affordably provide themselves. Juvenile offenders requiring intensive mental health services, sex offender treatment and other specialized treatment beyond the capacity of county-based services might be handled more effectively if CYA was refashioned to provide contract services to county consumers.
- *Expand the Availability and Use of Community Programs for Drug Treatment and/or Mental Health Services.* Community-based substance abuse treatment programs can be more cost-effective than institution-based programs. For some juvenile offenders, effective local drug treatment or mental health service programs can be at least as successful in meeting treatment needs without risk to public safety.



Trends suggest that CYA's population will continue to decline. This affords the Legislature with an opportunity to reduce costs . However, the Legislature should also consider strategies that can improve long term public safety by refocusing on treatment services and greater accountability.

*Analysis prepared by: Alison Anderson, Senate Public Safety Committee  
Alex MacBain, Senate Budget and Fiscal Review  
David Panush, Office of John Burton, President Pro Tempore  
Elizabeth Siggins, Senate Public Safety Committee*

## CHILD CARE AND DEVELOPMENT

In December, the Governor proposed to eliminate stage three child care. This proposal ends subsidized child care services for certain former CalWORKs participants. This essay provides background on the state's child care programs, outlines the Governor's proposal and outlines alternatives to the proposal.

**Background.** Under current law, families remain eligible for subsidized child care as long as three conditions are met:

- The parent or parents are in the work force,
- The family's income is at or below 75 percent of the state median (by family size), and
- The youngest child in care is no older than 13 years of age.

When the Legislature established the CalWORKs program in 1997, it provided three stages of child care services for families participating in welfare-to-work programs.

**Stage one** is roughly that time period when the cash-aid recipient participates in initial CalWORKs activities and looks for work. The county administers these stage-one funds. For the current year, the California Department of Social Services (DSS) reports that stage one child care enrolls 75,300 children from 39,600 families, with a budget of \$497.1 million. (Education Code §8351 establishes stage one.)

Once participants' schedules stabilize and they are in the labor force – or when recipients are transitioning off cash aid, they receive **stage two** services: these funds are administered by local child care and development programs under contract with the California Department of Education (CDE). CDE's current-year budget for stage two is \$622.9 million; an additional \$15 million goes to community colleges. CDE reports that approximately 104,000 children from 58,000 families receive stage-two care daily. (Education Code §8353 establishes stage two.)

In addition, there is a **reserve account for stages one and two** of \$101.5 million that is divided and distributed to counties and to child care agencies on an as-needed basis when the year's enrollment patterns become clear.

When a parent leaves cash aid and depends entirely on low-wage employment, the child care services come under the rubric of ***stage three***. In the current year, its budget is \$236.3 million. CDE reports that 51,000 children from 28,000 families are in care. (Education Code §8354 establishes stage three.)

Table 1  
Budget and Enrollment in Stage Three  
Dollars in Millions

<u>Stage</u>	<u>Budget</u>	<u>Enrollment</u>	
		Children	Families
One	\$ 497	75,300	39,600
Two	638	104,000	58,000
Three	236	51,000	28,000
Reserve	<u>102</u>	unknown	unknown
<b>Total</b>	\$ 1,473		

There are aspects of this structure that are important to note. These divisions among the three stages are not hard and fast. The Legislature purposely gave *flexibility to counties and child*

*care agencies* regarding when to move a child from one stage to another. When these moves occur, the family should feel no effect. Their child care arrangements should remain the same. Counties can determine when to move a family from stage one to stage two; the community agencies managing stage two and stage three determine when to shift families to the next stage.

***The Governor's Mid-Year and Budget-Year Proposal.*** In December of 2002, to save \$100 million between March and June 30 of 2003, and an additional \$400 million in the budget year, the Governor proposed to eliminate stage three care. This proposal ends subsidized child care services for former CalWORKs participants who have been off cash aid due to employment for 24 months or more, even though they would otherwise qualify for partial child care subsidies because of their low incomes.

Low-income working parents who have been off cash aid for more than 24 months would lose their child care subsidy.

There is a rationale for the Governor's proposal. Before 1997, when the federal Temporary Assistance for Needy Families (TANF) replaced Aid for Families with Dependent Children (AFDC), there was a limit on subsidized care within welfare to work programs. A family was limited to 24 months of "transitional child care" after leaving cash aid for a low-paying job. The Governor's proposal returns this aspect of child care to pre-welfare-reform status.

In addition, providing partial subsidies for the child care of low-wage workers who have left cash aid does put pressure on the General Fund: all CalWORKs participants who engage in welfare to work are entitled to subsidized child care. Because most former cash-aid recipients remain in low-wage jobs, they continue to qualify for partial child care subsidies. The Governor wants to put a time limit on this entitlement in order to control rising child care costs that result from the success of many aid recipients' entering and remaining in the low-wage workforce.

A large number of families currently enrolled in stage two have been off cash aid for more than 12 months. During the next 17 months, these families and all families currently in stage three will exceed 24 months since their last aid payment. Under the Governor's proposal, these families would cease to receive subsidized care, unless they moved into an opening in the programs funded through CDE separate from CalWORKs.

The Governor's proposal directly effects at least 50,000 children and as many as 80,000 children – from nearly 50,000 families. These parents have “played by the rules”: leaving cash aid, entering the workforce and remaining there. They are now part of the working poor.

Without child care assistance, some of these families might well return to the welfare rolls. Many others will patch together child care arrangements of poor quality and, in some cases, without basic health and safety features.

### **Cost-Saving/Cost-Shifting Options**

California's child care and development programs are rich in history, diverse in their organization, and sensitive to community needs. While the system has many regulatory nuances and can seem inordinately complex on first viewing, the structure is relatively straightforward.

The following pages discuss alternatives to the Governor's proposals for reducing General Fund costs for child care and development. They embody the following principles:

- Maintain or enhance the quality of care whenever possible.
- Focus on what particular agencies and programs do best.
- Include partners that have sources of funding outside the General Fund.
- Keep as much focus as possible on direct services to families.

All options, except option 6 (which makes the State Preschool program a partnership with county children and families commission), maintain the basic structure of the current system.

**1. Reduce the Percentage of Contract Funds Used for Administration and Support Services by Alternative Payment Programs. Potential Savings, \$15 Million To \$35 Million**

Currently, alternative payment programs (APP) administer close to two billion dollars of child care funds. These programs certify a parent's eligibility for care, assist them in finding care if necessary, pay the child care provider that provider's rates (up to a ceiling), and collect any fee the parent owes (based on the state's sliding scale). In addition, the APP is responsible for providing "locally designed support services for parents and providers ... [including] professional and technical assistance and information for providers [and] parenting information." (Education Code §8220.5) Further, an APP shall document that "subsidized children, as necessary and appropriate, receive supportive services" through the county and other community resources. (Education Code §8266.5)

To cover the costs of these administrative and support services, the APP contractor can keep up to 20 percent of its contract amount. In general, administrative costs are up to 15 percent of the contract total; support services are the remainder.

The Legislature can perhaps lower the cost of APP administrative services provided. Before budget subcommittee hearings begin, the CDE should meet with APP administrators to discuss streamlining the administrative process. Cost-saving possibilities include re-certifying a parent's continued eligibility for care less often and using electronic-benefit-transfer technology for attendance reporting and for paying providers.

Also, APP contractors provide a range of support services to children, to their families, and to child care providers. Which of those support services is essential? If it is possible for the Department of Education and the APP administrators to identify essential support services and estimate the cost of providing those. The Legislature could then adopt language defining those essential services and limiting expenditures to them. This reduction could be temporary – for the budget year only – and considered again in 2004.

In 1976, at the outset of APP contracts, support services were envisioned to include assessment and referral for health and social services that a child or family needed. Limiting support services to those might be a place the department and the APP administrators could begin their discussion.

Such actions on the administrative and support-service costs, taken together, could shave one or two percent off the contract total. Each percent reduced represents savings of nearly \$20,000,000 per year.

## **2. Change the Reimbursement Calculation for Licensed Facilities Caring Primarily For Subsidized Children. No Estimate: Savings Probably in the \$5 Million To \$10 Million Range.**

At present, no more than 75 percent of the children enrolled in a licensed child care center or family child care home can be subsidized through an alternative payment program. This rule is in effect so that licensed programs charge rates that are driven by the market, not by the maximum the state is willing to pay. (See Education Code §8222.5.)

The Legislature could remove the limit on the percentage of subsidized children enrolled at a center or licensed home. When the percentage of subsidized children rises above a designated percent (such as 60 or 75 percent), the facility would be reimbursed at the mean cost of care per child for that county.

This change would reduce state costs and make the state payments more reflective of the market rate.

## **3. Adjust Payments for License-Exempt Care to Reflect the Market Rate. Estimated Savings, \$30 Million.**

Currently, a family receiving subsidized child care can, under some circumstances, select a child care provider who is not licensed. These so-called “license-exempt providers” can be relatives, neighbors, friends, or strangers (nannies). These providers are exempt from licensure as long as they care only for the children of one parent in addition to their own children.

Providers are reimbursed on a per-child basis at 90 percent of the maximum reimbursement paid to a licensed provider within the county. (There is a county-by-

county calculation to establish the maximum amount a licensed provider can be paid. They are paid the rate they charge parents who are not subsidized or they are paid an amount equal to 1.5 standard deviations above the mean cost of care for their county – whichever is less.)

Instead of paying 90 percent of that top reimbursement level, the Legislature could set the rate for license-exempt providers at a percentage of the mean cost of care in a county – say, 80 percent or 90 percent of the mean. For example, in a county where the mean cost of full time care for a preschooler is \$100/week, a license-exempt provider would be paid \$90 (90 percent) or \$80 (80 percent) per week, rather than at \$112.50, which is the amount being paid in the current year (90 percent of \$125, the top rate paid to licensed providers in that county).

This option would provide substantial savings. This option should still give parents a full range of choices.

#### **4. Review “Quality Improvement” Expenditures and Work With the State’s Children and Families Commission To Identify Projects the Commission Could Adopt. Savings: \$20 Million To \$40 Million.**

Federal law requires that four percent of federal child care block grant be spent for “quality improvement programs.” For more than ten years, California has used this set-aside and additional funds to support the child care workforce.

Current expenditures finance community college coursework, stipends for master teachers to work with new teachers, and repay student loans. A portion of these funds augment the contracts of resource and referral programs, enabling them to provide more parents with information about their child care options. The budget for all quality activities in the current year is \$76.8 million.

Since Congress established the child care block grant and its quality set-aside, the voters of California have passed the Children and Families initiative (Proposition 10, 1998). A 50-cent per-pack surcharge on cigarettes provides funds for programs and services to children from birth to five years of age. A state commission and 58 county commissions receive \$600 to \$700 million in revenues each year.

The state commission manages three funds reserved for “education, including ... professional and parental education and training, ... the education and training of child care providers, ... [and] expenditures for the research and development of best

practices and standards for all programs and services relating to early childhood development” (Health and Safety Code §130100). These three funds receive 11 percent of the annual tobacco tax surcharge – a minimum of \$65 million per year.

Many of the current Quality Improvement Projects fit easily within the statutory language that guides the state commission’s expenditures. The commission has provided leadership on some of these same quality issues. The commission could identify Quality Improvement Projects which, though currently receiving state and federal funds, could be supported exclusively with state funds. This would free up federal funds that could be redirected to programs currently supported by the General Fund and that meet the federal Quality Improvement definitions. These include community care licensing activities and resource and referral services.

In addition, there may be projects currently funded through the Quality Improvement set-aside that county children and families commissions may want to adopt. During the budget process, the Legislature may want to direct the CDE to work with county commissions and their statewide association to identify those projects.

When proposing to use Proposition 10 funds in the budget year for activities currently provided by state and federal funds, some may ask if this is “supplantation,” as proscribed in the language of Proposition 10. (See Health and Safety Code §30131.4.) Legislative counsel could provide an opinion of the application of this section to a new budget year – if it would preclude the state commission or a county commission from funding an activity that is no longer supported by state or federal funds.

**5. Work With Head Start to Take Over More Part-Day Programs for  
Preschool-Aged Children – Limit State Preschool to Four-Year-Olds.  
Estimated Savings Up To \$45 Million.**

Both the state and the federal governments finance a part-day part-year program for three- and four-year-old children from low-income families. The federal program is Head Start; the state program is called State Preschool. When these two programs began in the mid-1960s, they received similar per-child funding. Over time, the Head Start per-child reimbursement increased more rapidly than has the State Preschool reimbursement.

Head Start’s average per-child reimbursement for preschool children is more than \$6,400, while State Preschool reimburses about half that. Head Start’s higher



reimbursement rates allows it to finance a higher level of services, such as support services for children and families.

From 1970 until 1990, Congress expanded Head Start to serve additional children. During this same period, California expanded its commitment to full-day full-year child care, while providing little in the way of new appropriations for State Preschool.

Since 1996, federal and state welfare policy has added significant pressure on low-income parents to join the workforce. As a result, part-day programs such as Head Start and State Preschool are in less demand. There are now many low-income communities in California where the demand for part-day preschool programs is fully met, while the demand for full-day and full-year child care continues to be greater than the supply.

The California Department of Education (CDE) and the federal regional Head Start office in San Francisco have a long-standing administrative collaboration. The Legislature could adopt options to reduce the size of the State Preschool program and direct the CDE to work with the Region IX office of Head Start to mitigate the impact of such reductions on any loss of local services:

- The Legislature could limit State Preschool enrollment in the budget year to four-year-olds and reduce budget-year contracts by each contractor's percentage of three-year-olds enrolled in the current year. Because about 15 percent of current enrollees are three, this would be a budget-year savings in the range of \$45 million from the General Fund. Savings might not equal 15 percent because small contractors would still need enough funding for a full classroom. In those instances, local coordination with Head Start could ensure full State-Preschool classrooms of four-year-olds, with Head Start serving more three-year olds. (See Education Code §8235 and §8236.)
- Any expansion in Head Start funding could, through coordination between CDE and Region IX, be focused on communities with current State Preschool classrooms: those classrooms could be phased out as Head Start increases enrollment.

Head Start would be the primary provider of part-day, part-year services to 3- and 4-year-old children from low-income families; and have CDE provide the lion's share of full-day, full-year child care and development services to the children of low-income working families. Over time, Head Start has proved itself in the part-day,

part-year arena. Future efforts to establish universal preschool within California will draw on the Head Start experience.

## **6. Invite Local Proposition 10 Commissions to Provide Leadership for Preschool Programs. Savings Up To \$155 Million.**

In the context of both the state's current budget difficulties and the recent report of the Joint Committee on a Master Plan for Education, the Legislature could explore the option of inviting county children and families commissions to become laboratories for the testing models for a universal preschool in California.

In the current year, the General Fund provides \$310 million to support the State Preschool program. (California Head Start programs receive \$800 million in federal funds.)

The Legislature could end the direct funding of State Preschool and enter into partnerships with county children and families (Proposition 10) commissions to fund and evaluate various approaches to preschool education. As such, the state would match local expenditures on a dollar-for-dollar basis, up to \$155 million (half this year's General Fund appropriation for State Preschool.)

Programs would have local design (e.g., The counties could set limits: Be available to four year olds only, be part day or be embedded in a full day; be means tested or be for all children.)

The counties, through their children and families commissions, would become "laboratories of change."

To ensure continuity of service within communities and to promote a wide range of approaches to preschool, the Legislature could make the matching funds available to counties in the same proportion that State Preschool funds are currently allocated.

## **7. Enact a Time-Limited Moratorium on New Enrollments in Alternative Payment Programs to Reduce Total Child Care Budget.**

Since 1989, subsidized child care has increased by more than \$1 billion (state and federal funds). Almost the entire amount is allocated within the Alternative Payment

Programs (APPs). Because APPs are flexible, it is easy for them to add new children. The Legislature could use this flexibility to manage costs. For example, it could:

- Place a six-month moratorium on replacing exiting families. There is a predictable turnover in enrollment every year, much of it happening during July, August, and September. By not replacing exiting families, savings to the General Fund would accrue.
- Set a target for savings. Ensure the savings are met by prohibiting enrollment until the target is reached. Only then would the California Department of Education authorize an APP contractor to enroll a new family after another family has exited the program.
- Guarantee contractors a fixed dollar amount for administration and support services for at least the first six months of the budget year.

By working with the APPs in this manner the Legislature could maintain current eligibility criteria for families and reimbursement rates for providers.

*Analysis prepared by:     Jack Hailey, Senate Office of Research  
                                     Amy Supinger, Senate Budget and Fiscal Review*

## REVENUE AND TAX PROPOSALS

The Department of Finance estimates General Fund revenues and transfers at \$69.2 billion in 2003-04. This is \$3.9 billion, or 5 percent, less than General Fund revenues and transfers in the current year. This essay covers the following issues:

- Tax Structure and Revenue Volatility
- The Governor's General Fund Tax and Revenue Proposals
- Other Tax and Revenue Issues the Legislature May Want to Consider
- Realignment Tax Proposals

The Governor maintains that there is a \$34.6 billion shortfall in the state budget for the 2002-03 and 2003-04 fiscal years. In December 2002, the Governor proposed urgency legislation to implement budget reductions totaling \$10.2 billion including \$3.4 billion in 2002-03 and \$6.8 billion in 2003-04.

The proposed budget including the December Revision proposes the following revenue proposals in the current and budget year:

- \$2.1 billion from transfers and other revenues.
- \$1.7 billion from loans and other borrowing.
- \$8.2 billion in tax proposals for State-Local Realignment.

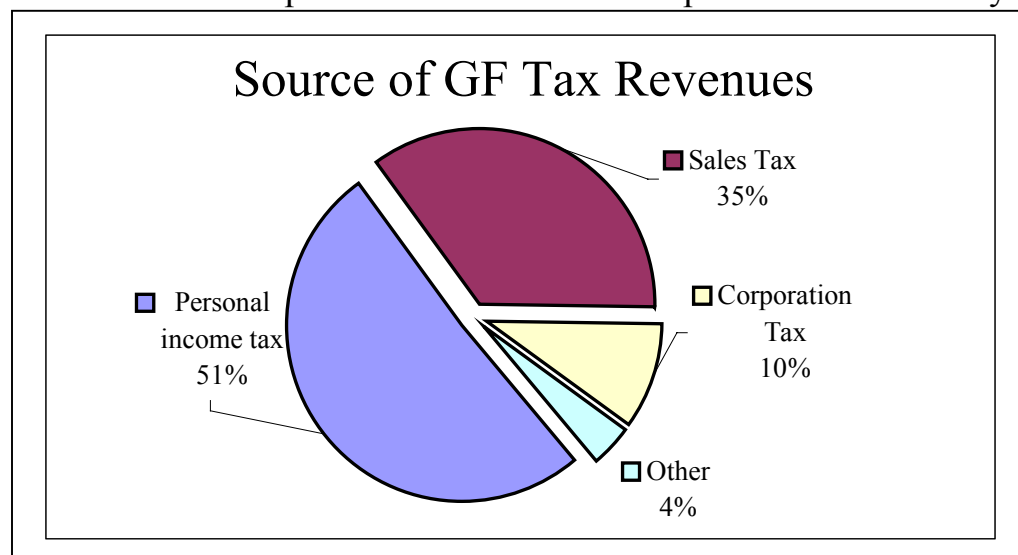
These issues are discussed in more detail below. Revenue and tax issues comprise \$12 billion of the \$34.6 billion deficit identified by the Governor.

## Tax Structure and Revenue Volatility

The following factors contribute to the volatility of the California tax structure:

- The personal income tax accounts for more than fifty percent of General Fund revenues.
- A significantly larger share of total state adjusted gross income is attributable to high-income taxpayers.
- Income of high-income taxpayers is subject to more variation than the lower income taxpayers.
- Individuals at the lower end of the income scale pay a very small share of the personal income tax.
- Nonwage income (capital gains, stock options) is a significant contributor to revenue fluctuations.

**Composition of General Fund Revenues.** The General Fund relies on the personal income tax for more than one-half of its revenues. This is the most volatile of the tax revenues. The income tax structure is very progressive and relies heavily on high-income taxpayers. Revenue from the sales tax accounts for 35 percent of total General Fund revenues. The sales tax base is a relatively slow growing revenue source. Over 85 percent of the General Fund tax base are from these two tax sources. A broader tax structure more dependent on less volatile aspects of the economy such

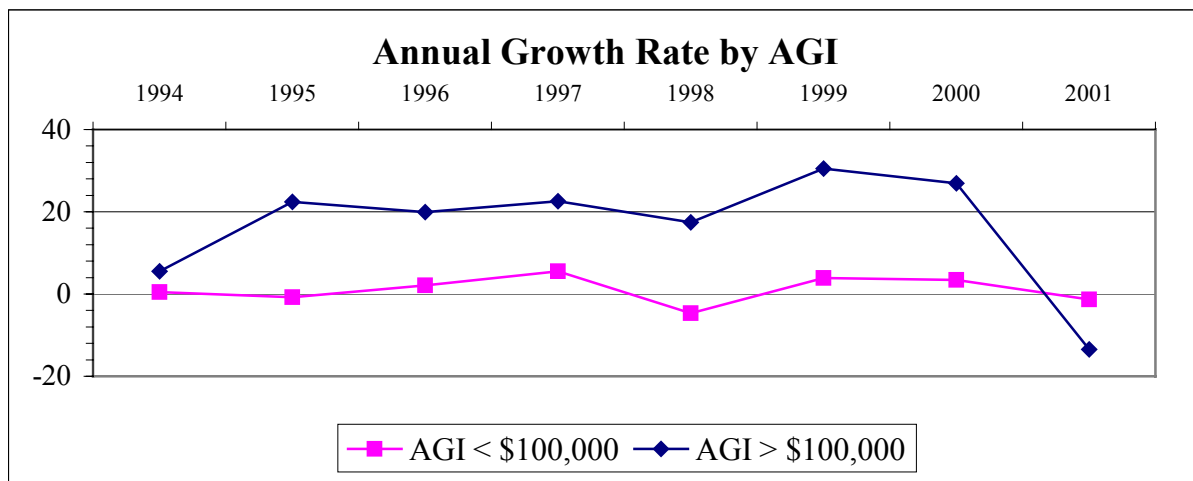


as property values or on a broader sales tax base would produce a more stable revenue base in both strong and weak economic circumstances.

### Personal Income Tax Derived from High Income Taxpayers

The top ten percent of taxpayers in California pay 80 percent of the personal income tax in California. This top ten percent of taxpayers have an adjusted gross income (AGI) of \$100,000 or more. Those taxpayers with AGI of \$100,000 or more have incomes that are much more volatile than those with incomes less than \$100,000.

The following chart shows the percentage change in total AGI for taxpayers with AGI less than \$100,00 and those with \$100,000 and above.



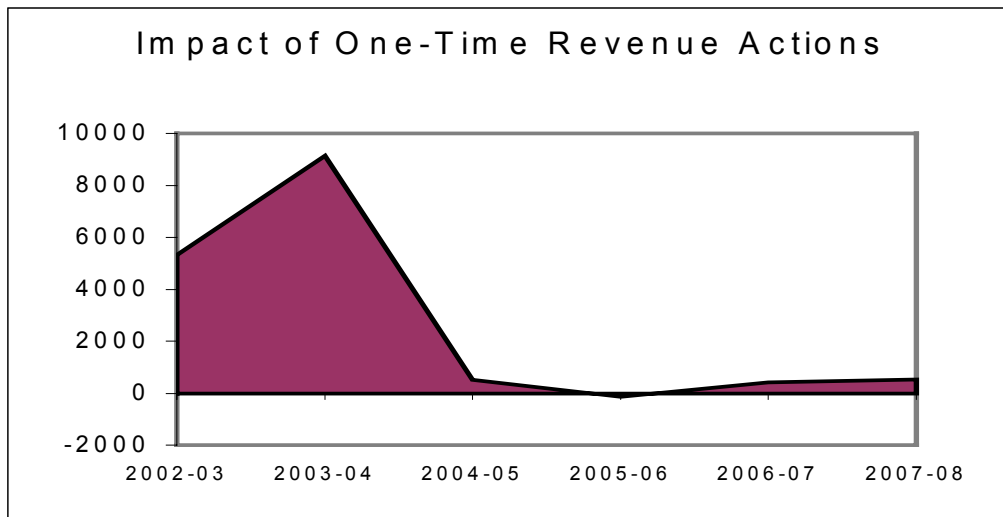
This chart shows that the AGI of taxpayers with higher incomes is much more volatile than the AGI of taxpayers with lower incomes. The AGI of these high-income taxpayers increases much faster than lower income taxpayers during strong economic periods and it decreases much more rapidly during weak economic periods.

### Impact of One-Time Revenues and Transfers

The volatility of the tax system in California is not the only revenue problem confronting the Legislature this year. In addition, many of the actions taken in the 2002-03 budget and proposed in the 2003-04 budget result in one-time increases in revenues. Actions taken to address the General Fund revenue shortfall in 2001-02

and 2002-03 did not address the structural problem in the state tax system. The revenue solutions consisted of revenue accelerations, increased audit and collection activities, suspension of tax incentives, and loans and transfers to the General Fund. These actions create an artificial increase in revenues that intensify the tax structure problem. The issues are discussed in the next section on General Fund Tax and Revenue Budget Proposals.

The following chart displays the one-time revenues from revenue accelerations,



increased audit and collection activities, tax proposals, suspension of tax incentives, borrowing, and loans and transfers.

## General Fund Tax and Revenue Budget Proposals

The following is a discussion of the tax and borrowing issues in the proposed budget.

### Tax Issues

#### *2003-04 Budget Proposals*

The following tax proposals would result in General Fund revenue effects.

**Regulated Investment Companies (RIC).** The budget proposes to prevent banks from utilizing RICs to avoid California tax by improperly sheltering income. The proposal includes language that would preserve FTB's ability to litigate the issue for years prior to those resolved by the proposed statutory change. This proposal would increase General Fund revenues by \$45 million in 2003-04, \$55 million in 2004-05 and \$65 million in 2005-06.

A RIC is a mutual fund that is eligible to pass the taxes on capital gains, dividends, or interest payments on to individual investors. RICs are exempt from paying federal and state income taxes. Federal law requires that RIC sponsors must sell shares to at least 100 private investors.

**Manufacturers' Investment Credit (MIC) Clarification.** The budget proposes to clarify that the MIC is intended to apply to manufacturing activities as specified in the Standard Industrial Code Manual. This clarification is intended to address a recent BOE decision to allow the MIC to be claimed by in-store bakeries and delis, two industries where there is little risk that the business owner will leave the state. This proposal would reverse the BOE decision and instead apply the FTB regulation limiting the application of the MIC to manufacturing firms. This would result in increased General Fund revenues of \$50 million in 2003-04, \$50 million in 2004-05, and \$30 million in 2005-06.

**Extension of the Sunset Provision for the Manufacturers' Investment Credit (MIC).** The intent of the MIC was to create manufacturing jobs and the enabling legislation sunset the MIC if manufacturing employment does not exceed a specified level. Based on the economic forecast in the budget, decreases in manufacturing employment would cause the MIC to sunset on January 1, 2004. The budget proposes to revise the sunset provisions to extend the sunset date to January 1, 2009. The budget does not highlight that the revenue loss from this extension is \$458 million in 2004-05 growing annually to nearly \$600 million in 2008-09.

**Indian Gaming Revenue.** The budget proposes to renegotiate Tribal-State Gaming Compacts with 61 federally recognized Indian tribes in 2003. There are also other federally recognized that have indicated an interest in negotiating compacts with the Governor. The budget assumes that the Administration can generate \$1.5 billion in revenue in 2003-04 and future fiscal years through revenue sharing agreements negotiated with the Compacts.

It is unlikely that this proposal will result in an additional \$1.5 billion in General Fund revenue, since the tribes have to agree to be taxed by the state. If Indian tribes agree to this revenue increase, the Compact would most likely have to include significant favorable changes in gaming for the Indian tribes.

## **2002-03 Budget Trailer Bill Tax Legislation**

The Legislature enacted two major tax packages in 2002-03. Before enactment of the budget, legislation was enacted to conform California income tax law to federal law relating primarily to retirement plans, pensions, IRAs, and deferred compensation plans. A budget trailer bill also contained tax and revenue acceleration provisions.



### ***Pension and IRA Conformity***

In May 2002, the Governor signed SB 657 (Scott) and AB 1122 (Corbett) which conformed California income tax law to federal Economic Growth and Tax Relief Reconciliation Act of 2001 relating to retirement plans and certain trusts, including provisions relating to annuities and certain proceeds of life insurance contracts, IRA's, employee annuities, qualified state tuition programs, retirement savings, deferred compensation plans, employee-funded pension trusts, and group legal service plans. These bills also contained conformed California income tax law to selected federal law changes enacted in 1998, 1999, and 2000. This bill resulted in increased revenues of \$189 million in 2001-02, no net fiscal impact in 2002-03, and a revenue loss of \$10.5 million in 2003-04.

### ***2002-03 Tax Budget Trailer Bill***

The 2002 tax budget trailer bill implemented the tax and revenue provisions related to the 2002-03 budget compromise. The package increased General Fund revenues in 2002-03 by approximately \$2.4 billion and \$800 million in 2003-04. The bill reduces annual General Fund revenues in 2004-05 and fiscal years thereafter by about \$500 million. The trailer bill primarily contained one-time revenue accelerations offset by tax incentives in future fiscal years. Chapter 488 included the following tax provisions:

**Suspension of Net Operating Loss Deduction.** Deferred the net operating loss (NOL) deduction for tax years 2002 and 2003. The availability period for deducting these losses was extended for an additional two years.

Current law allows a NOL carry forward deduction of 60 percent for a period of up to ten years. This amount was scheduled to increase to 65 percent commencing January 1, 2004. AB 2065 increased the NOL deduction to 100 percent effective January 1, 2004.

This provision results in increased revenues of \$1.2 billion in 2002-03 and \$800 million in 2003-04. The increase in the NOL deduction to 100 percent will result in on-going General Fund revenue losses of about \$500 million commencing in 2004-05.

**Withholding on Stock Options and Bonuses.** Increased withholding for stock options and bonuses from 6 percent to 9.3 percent, effective for payments on or after January 1, 2003. This will result in one-time increased revenues of about \$400 million in 2002-03.

**Withholding on Real Estate Transactions.** Imposed withholding on the sale of commercial property for California residents to conform to the withholding

provisions for nonresidents. Current law requires nonresidents to withhold 3.5 percent of the purchase price of commercial property for personal income tax purposes. AB 2065 extended this same treatment to residents of the state. This provision will result in one-time revenue increases of \$225 million for 2002-03.

The bill provides an exemption from withholding for transactions involving like-kind exchanges, involuntary conversions, and loss on the sale of the property. The bill, however, inadvertently omitted provisions that would allow the Franchise Tax Board (FTB) to waive the withholding under certain circumstances. The FTB can waive withholding on the sale of property by nonresidents in cases where there is little or no gain on the sale or the withholding would exceed the tax liability from the sale.

**Conform to Federal Law on Bad Debt.** Changed the methodology for calculating deductions for bank bad-debt losses under the Bank and Corporation Tax to conform to federal law. Commencing with the 2002 tax year, the bill requires banks with more than \$500 million in assets to deduct losses in the year in which they become worthless rather than allow these banks to deduct 50 percent of their existing bad-debt reserve balances. This change will result in a one-time increase in General Fund revenues of \$285 million in 2002-03.

**Suspend the Teacher Tax Credit.** Suspended the Teacher Tax Credit for the 2002 tax year. This credit is available to credentialed teachers and varies from \$250 to \$1,500 per year, depending on the length of the teacher's service. This will result in a one-time revenue increase of \$170 million in 2002-03.

**Collections on High Risk Accounts.** Authorized FTB and Board of Equalization (BOE) to forgive any penalties, interest, or fees on unpaid income tax and sales tax accounts if the outstanding tax liability is paid. The FTB and BOE identify the taxpayers with high-risk accounts and have the authority to offer this special treatment to those taxpayers. This authority is limited to the period October 1, 2002 through June 30, 2003. General Fund revenues are expected to increase by \$145 million in 2002-03.

## **Loans and Transfers**

Both the 2002-03 and 2003-04 budgets rely heavily on loans and transfers from special funds. In addition, several proposals involved borrowing of outside funds to pay current obligations or to secure future financing.

The proposed budget includes loans from special funds of \$148 million and transfers of \$107 million. It includes \$1.5 billion in pension obligations bonds, which will result in a one-time General Fund revenue increase.

The 2002-03 budget authorized loans and transfers from special funds to address the shortfall in the General Fund. Loans to the General Fund total slightly more than \$2 billion and transfers are more than \$500 million. In addition, the budget package included the securitization of \$4.5 billion of Master Tax Settlement payments scheduled to be paid to the state over the next twenty years.

### ***Loans and Transfers from the General Fund***

The loans and transfers from special funds to the General Fund were made from special funds that had available resources that could be used to address the General Fund shortfall. The transfers of \$500 million in the current year and \$107 million proposed for the December Revision and the budget year are one-time, but are not required to be repaid to the fund. The loans of \$2 billion in the current year and \$148 million in the budget year are generally from funds with statutory or constitutional restrictions on the use of funds and must be repaid.

Chapter 1124, Statutes of 2002, (AB 3000) sets conditions for the loans from special funds to the General Fund. This same trailer bill language is proposed for both current year and budget year loans. Money may be loaned from one state fund or account, if the following conditions are met:

- The loan is authorized in the Budget Act,
- The terms and conditions of the loan are set forth in the loan authorization, including an interest rate,
- The loan is considered part of the balance of the fund or account, and
- Fees and assessments will not be increased as a result of the loan.

Loaned moneys may not be considered a transfer of resources for purposes of determining the legality of using the funds. The Director of Finance is required to order the repayment of all or a portion of the loan if either the fund or account *making the loan* needs cash, or the fund or account *receiving the loan* does not need the money.

### ***Repayment of Loans by Fiscal Year***

The estimate of the General Fund cost of loan repayments is \$450 million in 2004-05, \$887 million in 2005-06, \$345 million in 2006-07, and \$50 million in years

thereafter. The one-time benefit from these loans will be more than offset by the cost to the General Fund in future fiscal years for repayment of these loans.

## **Other Borrowing**

### ***Pension Obligation Bonds***

The budget proposes legislation to authorize pension obligation bonds of \$1.5 billion to fund the state's budget year retirement obligations to both CalPERS and STRS. Although the Administration requested action on this issue in the First Extraordinary Session, no specific proposal or trailer bill language has been provided. The budget summary indicates that the Administration will also be conferring with CalPERS and STRS about the possibility of a loan of the same amount. This proposal would need to be enacted by June 30 to suspend the payment of the PERS and STRS contribution in 2003-04.

This proposal would effectively increase General Fund revenues by \$1.5 billion in 2003-04. These funds would be used to make the budget year contribution to PERS and STRS and would be repaid over some yet undetermined time. Thus, this proposal would provide one-time funds of \$1.5 billion with an obligation to repay the funds.

### ***Master Tax Settlement Securitization***

In a 2002 budget trailer bill, the state was authorized to borrow \$4.5 billion in future payments due the state from the Tobacco Settlement Fund. This represents one-half of what California is owed over the next twenty year. This one-time infusion of revenue in 2002-03 will be repaid over twenty years at nearly \$500 million per year commencing in 2003-04. This proposal again exacerbates the tax structure problem the state faces.

## **Other Tax Issues the Legislature May Want to Consider**

Given the magnitude of the budget problem, the Administration and the Legislature will likely look at other revenue and tax proposals for 2002-03 and 2003-04.

### **Vehicle License Fees**

Current law imposes an annual vehicle license fee (VLF) on any vehicle subject to registration in this state equal to 2 percent of the market value of that vehicle. The VLF is in lieu of any ad valorem property tax upon vehicles. The market value of the

vehicle is determined by the purchase price and depreciated over the life of the car. For vehicle license fees due after July 1, 2001, the VLF is “offset” or reduced by 67.5 percent. The Controller is required, upon receipt of monthly notification from the Department of Motor Vehicles of the amount of offsets applied, to transfer state General Fund moneys to reimburse local governments for losses resulting from the vehicle license fee offset.

If there are insufficient moneys in the General Fund for the Controller to fully reimburse local governments for the loss in VLF, current law requires the offset amount to be reduced in proportion to the shortfall in funding available to reimburse local governments for those losses. Existing law does not designate the person or agency responsible for making the determination of whether there are sufficient moneys in the General Fund to make these reimbursements.

The Legislature approved AB 4X in February 2003. AB 4X would require the Director of Finance to make the determination of whether there are insufficient moneys in the General Fund for the Controller to reimburse local governments for their losses resulting from the VLF offsets.

AB 4X also clarifies that the term "General Fund", as used with reference to the vehicle license fee offset, has the same meaning as set forth in Section 16300 of the Government Code. It also provided that the term "General Fund" does not include any moneys that the state is obligated to repay to the source from which those moneys were received, or any moneys in that fund that are derived from loans or other forms of indebtedness.

The Governor indicated on February 4 that he planned to veto AB 4X.

### **Expand Sales Tax Base to Include Services**

There have been various proposals to expand the sales tax base to include all or selected services. The question of which specific services should be taxed is a difficult policy decision.

Current law provides that the sale of services where no tangible personal property is transferred or where the transfer of property is incidental are not subject to sales and use taxes. Instead, persons that provide services are considered consumers of property used in their business activities and thus are subject to the sales and use tax. If the service supplier sells any tangible personal property to their customers, the tax applies to that sale.

Certain services are defined as sales of tangible personal property. An example of a taxable service would be the charge for fabrication of tangible personal property is

considered a taxable sale even when the consumer provides all the tangible personal property used to fabricate the final product.

Numerous services could be subject to a sales and use tax or an excise tax rate. Services can generate a substantial amount of revenue even at a relatively low rate. Some of the major service areas that would generate significant revenues are:

- Automotive Repair Services
- Custom Computer Programs
- Janitorial Services
- Admission Charges
- Lodging
- Cable TV/ Satellite TV
- Accounting and Bookkeeping Services
- Legal Services
- Cell Phone Services
- Engineering, Architectural and Surveying Services
- Management, Scientific and Technical Consulting Services

### **Equity Issues**

A number of equity issues arise in determining which services should be subject to a sales and use tax or excise tax.

- Some of the services are already taxed at the state or local level.

Admissions, lodging, and cable TV are frequently subject to local excise taxes at various rates throughout the state.

The charge for intrastate cell phone services are subject to state tax at a rate of 0.72 percent for the State Emergency Telephone Number Account (911 Account). The budget proposes increasing this rate to 1.0 percent.

- Can result in unequal treatment of businesses.

Businesses that have their own legal or accounting divisions would not be subject to a tax on services, while those businesses that contract out would

be subject to the tax. Larger businesses are more likely to have legal or accounting divisions than smaller businesses.

### ***Sales and Use Tax or Specific Tax Rate***

The current sales tax rate (state, local, or combined) could be imposed on selected services or a state excise tax could be imposed on those services.

### **Revenue Proposals Related to Realignment**

The Budget proposes the following state tax increases related to county realignment. The revenues would be deposited in the Enhanced State and Local Realignment Fund. Revenue in funds other than the General Fund are not subject to the Proposition 98 Guarantee. The proposed increases in rates and 2003-04 revenues are as follows:

• Increase sales tax rate by one cent	\$4.6 billion
• Add 10 and 11 percent personal income tax rates	\$2.6 billion
• Increase cigarette tax by \$1.10 per pack	<u>\$1.2 billion</u>
Total Revenue	\$8.4 billion

This revenue would be deposited in the new Enhanced State and Local Realignment Fund. This revenue would fund realignment of state and local health and social services programs. In addition, loss of revenues to the special funds that receive cigarette tax revenues would be reimbursed for any loss resulting from decreased taxable distributions resulting from the cigarette tax increase.

### ***Increase Sales Tax Rate by One Percent***

The budget proposes a one-cent increase in the sales and use tax rate effective July 1, 2003. This would increase revenues by \$4.6 billion in 2003-04.

The current state and local sales and use tax rate is as follows:

	<b><u>Sales and Use</u></b>	<b><u>Comments</u></b>
	<b><u>Tax Rate</u></b>	
<b><u>State Rates</u></b>		
General Fund	5.00	Based on General Fund reserves, this rate may be temporarily reduced to 4.75 percent.
Local Revenue Fund	0.50	Dedicated to counties for state-local realignment.
<b><u>Local Uniform Rates</u></b>		
Bradley-Burns	1.00	Imposed by city and county ordinance for general purpose.
Transportation Rate	0.25	Dedicated for county transportation purposes.
Local Public Safety Fund	0.50	Dedicated to counties for public safety purposes.
<b><u>Local Add-on Rates</u></b>		
Transactions and Use Taxes	Up to 2.00	Levied in 0.25 percent increments in any county. Requires approval by the Board of Supervisors plus two-thirds of the electorate.
		For most counties, the maximum rate is 1.50 percent. The limit is 2.00 percent in San Mateo County, 1.75 percent in San Francisco County, and 1.00 percent in San Diego County.

Counties without add-on rates have a total sales and use tax rate of 7.25 percent. The highest state and local rate imposed is 8.50 percent in San Francisco County. If the



increased sales and use tax rate of 1.00 percent were enacted, the highest state and local rate imposed in California would be 9.5 percent.

### ***Sales and Use Tax Rates in Other States***

There are 8 states and the District of Columbia that have a maximum state and local sales and use tax rate equal or greater than 8.5 percent. These are the highest rates imposed anywhere in those states and are not uniform state and local sales tax rates. The rates in those states are as follows:

<b><u>State</u></b>	<b><u>Maximum State/Local Rate</u></b>
Alabama	9.00
Arizona	8.60
Florida	8.50
Illinois	8.75
Louisiana	9.50
New York	8.50
Oklahoma	9.75
Tennessee	8.75
Washington, D.C.	8.80

If California were to adopt the proposed one percent sales and use tax rate increase, there would be one state (Louisiana) with the same maximum rate and one state (Oklahoma) with a higher sales tax rate than California.

### ***Add 10 and 11 Percent Personal Income Tax Rates***

The budget proposes to add the following income tax rates. It adds the following income tax rates for the following filers:

<b>Filing Status</b>	<b>10 Percent Rate Applies to Taxable Income Above:</b>	<b>11 Percent Rate Applies to Taxable Income Above:</b>
Single Filers	\$136,115	\$272,230
Joint Filers	\$272,230	\$544,460
Head of Household	\$185,275	\$370,550

The current personal income tax is progressive, with rates ranging from 1 percent to 9.3 percent. Personal, dependent, and other credits are allowed against the gross tax liability.

These increased rates apply to taxable income, not adjusted gross income (AGI). Certain items are deducted from gross income to calculate AGI. Items that can be deducted in calculating AGI include IRA contributions, fifty percent of self-employment tax, self-employed health insurance deductions, penalties on early withdrawal of savings; alimony paid; and moving expenses. Taxable income is AGI less the standard deduction or itemized deductions. Itemized deductions include items such as interest on mortgages, charitable contributions, certain state and local taxes, or medical expenses.

### *Issue*

In California, personal income taxpayers do not pay state taxes until they have a relatively high AGI. The following chart indicates the taxation threshold by AGI both with and without the Renter's Credit. AGI gives a better reflection of an individual's or family's income level than taxable income.

#### **Tax Threshold for the 2002 Tax Year by Adjusted Gross Income**

<b><u>Filing Status</u></b>	<b><u>Without Renters' Credit</u></b>	<b><u>With Renters' Credit</u></b>
<b><u>Single</u></b>		
No dependents	\$9,955	\$12,955
One dependent	\$19,655	\$21,155
<b><u>Married Filing Joint Return</u></b>		
No dependent	\$19,859	\$25,859
One dependent	\$32,459	\$36,059
Two dependents	\$39,359	\$42,359
<b><u>Head Of Household</u></b>		
One dependent	\$28,459	\$34,059
Two dependents	\$37,359	\$40,359

Thus, an average married couple with two children would pay state personal income tax if their income were more than \$42,359 per year. The state tax rate of 1.0 percent would apply to the first \$11,668 of income over \$42,359.

### ***Cigarette Tax Increase Proposal***

The budget proposes a tobacco tax increase of \$1.10 per pack that would become effective July 1, 2003. This is expected to generate \$1.2 billion in 2003-04 and \$1.1 billion in 2004-05 according to the Department of Finance.

The current tax on cigarette and other tobacco products are as follows:

<b><u>Fund</u></b>	<b><u>Rate Per Pack</u></b>	<b><u>Use of Funds</u></b>
General Fund	\$0.10	Not earmarked for any purpose.
Proposition 10	\$0.25	California Children and Families First Trust Fund to develop a statewide system of information and services for early childhood development.
Proposition 99	\$0.50	Cigarette and Tobacco Products Surtax Fund to support anti-smoking education programs, tobacco-related disease research, indigent health care, and public resources.
Breast Cancer	<u>\$0.02</u>	Breast cancer research.
<b>Total</b>	<b>\$0.87</b>	
Proposed increase	\$1.10	State and Local Realignment
<b>Proposed Total</b>	<b>\$1.97</b>	

This increase is expected to reduce taxable consumption of tobacco products by an additional 11 percent, in addition to the normal baseline decline in taxable consumption of tobacco products that has occurred since the major increases in the tobacco tax. The existing special funds that receive tobacco tax revenues will

experience a reduction of approximately \$96 million in 2003-04. Proposition 99 revenues will be reduced by \$31 million, Proposition 10 revenues will be reduced by \$62 million, and the Breast Cancer Fund will be reduced by \$2.5 million. Revenues from the proposed tax increase will reimburse these funds for the reduced revenues from the decrease in taxable distributions.

### ***Taxes in Other States***

According to the Federation of Tax Administrators, California has the 12<sup>th</sup> highest state rate in the United States. If this proposal were enacted, California would have the highest state tax rate. New York has a state rate of \$1.50 per pack and New York City imposes an additional rate of \$1.50 per pack, so the state and local rate is \$3.00 per pack.

*Analysis prepared by Judi Smith, Senate Budget and Fiscal Review*